

1957

## Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement

Robert O. Swados

Follow this and additional works at: <https://ir.lawnet.fordham.edu/flr>



Part of the [Law Commons](#)

---

### Recommended Citation

Robert O. Swados, *Death and Nonsense: The Decline and Fall of the Buy-Sell Agreement*, 26 Fordham L. Rev. 189 (1957).

Available at: <https://ir.lawnet.fordham.edu/flr/vol26/iss2/1>

This Article is brought to you for free and open access by FLASH: The Fordham Law Archive of Scholarship and History. It has been accepted for inclusion in Fordham Law Review by an authorized editor of FLASH: The Fordham Law Archive of Scholarship and History. For more information, please contact [tmelnick@law.fordham.edu](mailto:tmelnick@law.fordham.edu).

# DEATH AND NONSENSE: THE DECLINE AND FALL OF THE BUY-SELL AGREEMENT

ROBERT O. SWADOS\*

## PROLOGUE: A FACTUAL FABLE

**T**HOMAS LINCOLN was a dutiful, hard-working son who had devoted fifteen years to the pursuit of his father's profit in the family business, the Lincoln Specialty Store, Inc. As a reward for his industry, his father, Silas, had furnished him with an occasional kind word and with 500 of the 1500 shares of Lincoln issued and outstanding (on which no dividends had ever been paid—Silas did not believe in dividends), but had never been willing to relinquish control in any respect. Because of Tom's hard work, good luck, inflation, or the mere passage of time, the book value of the stock had increased from \$100 to \$500 per share, and the earned surplus to more than \$500,000, when Thomas was suddenly confronted with the fact of the second marriage of his father, whom he had long considered to be a permanent widower. Armed with the incisive but cheerful phrases of a university tax panel, and somewhat disturbed by the financial rearrangements which might follow upon the acquisition of a stepmother, Thomas descended upon his father, and persuaded him to submit to the advice of a quadri-partite estate planning "team."

The result of this high-powered and high-priced conference was a highly-polished buy-sell agreement: trustee, funded by life insurance, the premiums on which (\$10,000 per year) were paid by the corporation, and providing that on the death of either, the survivor would cause the corporation to purchase and the estate of the deceased would sell all shares owned by the decedent's estate at a price to be fixed by an independent appraiser based upon the book value.

Five years passed and Silas departed this world, serene at least in the knowledge that he had arranged his affairs in an orderly, intelligent way based upon competent advice. While he left most of his estate to his wife and the children of his second marriage, he did not forget his son, bequeathing to him the family photographic album.

When the settlement of the affairs of the estate had been got under way, Thomas appeared at tax counsel's office, eager to see the machinery which had been so intelligently established (based upon fine precedents) work smoothly in the use of the insurance proceeds for the purchase of his father's shares and Tom's acquisition of control. The shocks which ensued were rather disheartening.

---

\* Lecturer on Law, University of Buffalo, School of Law.

Shock number one was the appearance of a personable internal revenue agent, who advised—with a trace of a grin on his face—that the premiums (aggregating \$50,000) which had been paid by the corporation on insurance to fund the buy-sell agreement, even though no deduction had been taken by the corporation for the cost of the premiums, were to be treated as taxable income to his father and himself, on the ground that the buy-sell agreement was really for the benefit of the stockholders of the corporation, not for the benefit of the corporation itself, and that accordingly both he and his father owed substantial income taxes for all the open years during which premiums had been paid.<sup>1</sup>

The second shock came from tax counsel himself. He ruefully exhibited two sections of the Internal Revenue Code of 1954 and advised Thomas that the effect of the intricate and complex language was to treat Tom as if his father's estate owned his stock, so that if the corporation used the insurance proceeds or any other funds to purchase the father's stock, the transaction would be a taxable dividend either to his father's estate or to Thomas because the earned surplus of the corporation was at least equal to the purchase price of the stock.<sup>2</sup>

When Thomas replied that if it was a dividend to the estate he didn't mind that so much because his stepmother was the primary beneficiary, tax counsel had to admit that, well, perhaps there was another problem which might give considerable difficulty. It seemed that while the price called for by the buy-sell agreement was \$500 per share and there were sufficient funds in the corporation to pay that price, the examining agent in the Estate Tax Division of the Internal Revenue Service was unwilling to accept the value fixed in the buy-sell agreement. He looked not only at the book value, but at the earnings of the corporation, the present market value of its properties and other factors which he insisted were relevant.<sup>3</sup> His proposed valuation was \$1,200 a share, or a total value of \$1,200,000 rather than \$500,000, which would result in additional estate taxes of \$400,000 which somebody would have to pay.

Thomas responded, "Well, that's not too serious either, that's also the widow's problem." "I'm afraid," said the tax counsel, "that isn't quite so. Some judge in the New York courts has indicated rather strongly that since you get the stock, *you* owe the additional \$400,000 in federal estate taxes."<sup>4</sup>

Whereupon Thomas, a former left tackle, seized Volume 1 of Prentice-Hall in his left hand, Volume 2 of CCH in his right, and dropped them

---

1. Henry E. Prunier, 28 T.C. No. 4 (April 12, 1957).

2. Rev. Rul. 56-103, 1956-1 Cum. Bull. 159.

3. Estate of Fitts v. Commissioner, 237 F.2d 729 (8th Cir. 1956); Rev. Rul. 54-77, 1954-1 Cum. Bull. 187.

4. In the Matter of Galewitz, 3 A.D.2d 280, 160 N.Y.S.2d 564 (1st Dep't 1957).

simultaneously on tax counsel's fragile skull. He then placed the nearest volume of Mertens under the poor solicitor's head as a pillow, removed the red spots from the carpet with a few pages of the *Journal of Taxation* and the *Tax Barometer*, went to the nearest police station and gave himself up. When the desk sergeant inquired as to the reason for the crime, he could only mutter, "Tax Ideas"! In the ensuing trial on charges of assault, he was defended by a resourceful trial lawyer who succeeded in excluding from the jury all lawyers, accountants, insurance men, trust officers, internal revenue agents, and any and all persons who might by reason of the application of the attribution rules in section 318 of the Internal Revenue Code be or be considered to be related to lawyers, accountants, insurance men, trust officers, or internal revenue agents. Thomas was acquitted amidst shouts of "Olé!"

#### THE DECLINE AND FALL

While this little story of the troubles of Thomas may be a fable, it is hardly fiction. For recent decisions, rulings and statutes, together with the Commissioner's proposed regulations, have cast such a pall on the use of the buy-sell agreement as to cause all of those who deal with estate planning to reconsider whether the game is worth the candle at all. Whether it is because the tax tail has begun to wag the estate planner's dog, or because the appealing quality of life insurance has caused the buy-sell device to be oversold, we shall leave to other speculation. But the decisions and rulings discussed in this article suggest strongly that we take this principal tool out of counsel's bag, set it up on the desk, and examine it critically to see if the shocks administered by the courts and the Treasury Department have left us with an instrument which is, as it was intended to be, a means of effecting a smooth transition in the affairs of a corporation upon the death of a principal stockholder, or a paper whose major product is litigation.

An understanding of the basic structure of a buy-sell agreement is fundamental to further discussion. Its primary use is in the area of the closely-held corporation, where no ready market exists for the shares of the company and at the same time the death or departure of one of the principal stockholders automatically brings about a radical problem of control and working relationship for the survivor. Its primary justification, then, is to provide a market or a means of translating stock ownership into cash or other property, and to assure the stockholder remaining in the business that his operation of the concern will not be interfered with by the transferee or distributee of the departing stockholder's shares. To bring about this happy transition, the following arrangements must be made. First, price must be agreed upon, or at least a formula or procedure established for settling the price. Second, there

must be some restrictions on the sale of the stock so that the survivor can be sure that the sale or gift or other transfer during his co-partner's life will not defeat the purpose of the buy-sell arrangement. Third, funds must be made available for the purchase of the departing stockholder's shares (and it is here that the use of life insurance has become so popular). Finally, it must be decided whether the corporation will purchase the shares of the departing stockholder (a redemption agreement) or whether the remaining or surviving stockholder shall do so (a "cross-purchase agreement").

The stock of a closely-held, owner-operated corporation is, more often than not, the principal asset of the stockholder's estate. Today's tax rates make it difficult for the stockholder to accumulate any independent estate outside of his shares in the corporation. In the usual case, therefore, funds must be provided in part or in whole by the company for the purchase by the surviving (and usually younger) stockholder. Accordingly, the stock redemption agreement, except for the tax perils which have suddenly grown more ominous, is the most practical logical machinery for carrying out the buy-sell arrangement.

As long as the buy-sell arrangement was devoted to its basic purpose of effecting a smooth transition in the change of ownership it encountered no basic difficulties. It was held to be lawful, enforceable, not the substitute for a testamentary disposition, and not in violation of the widow's statutory share.<sup>5</sup> When it began to be used, not only among unrelated parties, but in family arrangements as a substitution for testamentary dispositions, and, one must confess, with the probably unjustified hope that it would in such situations irrevocably fix the valuation of the shares in the corporation for federal estate tax purposes, the attention of the Treasury was invited. It is possible that many buy-sell arrangements were effected for estate planning and tax valuation objectives, with the business transition purpose either subordinate or non-existent.

In recent decisions and rulings the Treasury and the courts appear to have mounted an all-out assault on each element of the buy-sell arrangement.

### *The Definition of Price*

Here, as elsewhere in this field, counsel as draftsman is not left to his own devices. The Commissioner of Internal Revenue is constantly pushing at his pen, and the results frequently are neither artistic nor effective. Obviously, even if Silas and Thomas could agree on what they consider to be the value of the corporate shares today, the quarrel might be

---

5. See *Aron v. Gillman*, 309 N.Y. 157, 128 N.E.2d 284 (1955); *In the Matter of Galewitz*, 206 Misc. 218, 132 N.Y.S.2d 297 (Surr. Ct. 1954), *aff'd*, 285 App. Div. 947, 139 N.Y.S.2d 897 (1st Dep't 1955).

violent tomorrow. Even "book value," the most obvious of valuation concepts, creates trouble, and with fluctuations in market values, inflation, the use of rapid depreciation methods, the discretion permitted or employed in practice between expensing some items and capitalizing others, it is difficult to obtain a completely satisfactory definition of book value, let alone agreement upon its use. The best solution seems to be a formula which takes into account the various factors which contribute to value: net worth per books, earnings per share (after discounting or adding back part of any salary or bonus which may be considered abnormal), dividends—if any, appraisal of real property, even good will. The more factors the formula comes to grips with, the more likely the arrangement is to produce equity for the participants and satisfy the Commissioner of Internal Revenue as well. But here also frustration is encountered. For even such appealing formulae as that hoary specimen of Treasury wisdom, A.R.M. 34,<sup>6</sup> are out; the Commissioner has instead given us an interesting compendium of the factors which the Treasury considers internal revenue agents should take into account in the numbers game that constitutes the valuation of the stock in a closely-held corporation. One would expect that if counsel took reasonable care to arrive at a fair valuation of the shares, and under a formula based upon the principal factors involved, he would have a reasonable assurance that the valuation so arrived at would be accepted by the Treasury. But Revenue Ruling 54-77<sup>7</sup> offers no assurance whatsoever.

---

6. 2 Cum. Bull. 31 (1920), where the treasury suggested a pattern for the valuation of good will, later followed with variations by state and federal courts, of computing "standard" earnings at 10% of average tangible assets, then capitalizing the excess earnings at 5 times or more.

7. Rev. Rul. 54-77, 1954-1 Cum. Bull. 187, at 183-S9:

"SEC. 3. APPROACH TO VALUATION.

.01 Determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in the estate and gift tax cases. . . .

". . . .

"SEC. 4. FACTORS TO CONSIDER.

.01 . . . the following factors, although not all-inclusive, are fundamental and require careful analysis in each case:

(a) The nature of the business and the history of the enterprise, including the date of incorporation.

(b) The economic outlook in general and the condition and outcome of the specific industry in particular.

(c) The book value of the stock and the financial condition of the business.

(d) The earning capacity of the company.

(e) The dividend-paying capacity.

(f) Goodwill.

In refusing to help the quest for certainty in this field the Commissioner and, to some extent, the courts, have acquiesced in a fascinating pastime which might be called "Revenue Roulette." Consider, for example, the scatter-shot valuations of the shares of a closely-held company in *Estate of Fitts v. Commissioner*.<sup>8</sup> In a proceeding fixing the estate tax valuation in the estate of a Mrs. Webster, who died within seven months of Cora Fitts, the Treasury agreed to a valuation of the shares in the Fitts Dry Goods Company at \$200 per share. But when the Fitts executors included the stock in the federal estate tax return at \$150 a share, the Commissioner entered a deficiency assessment on the basis of the value of the stock at \$600 per share. Finally, a majority of the judges on the court of appeals affirmed a finding by the Tax Court that the value was \$375.

As authority for its determination the court quoted approvingly from Revenue Ruling 54-77, but offered no clue as to the reasoning or mechanics by or through which the generalities of that ruling were given meaning. There are a few coincidences which indicate that the principle employed by the majority of the court was simple, perhaps overly simple, arithmetic: value in federal estate tax return \$150; value in deficiency letter, \$600;  $\$600 \div \$150 = \$750$ ;  $\$750 \div 2 = \$375$ . This simple average, which was the finding of the Tax Court accepted by the court of appeals, led the dissenting judge to remark that "this is reminiscent of the pun about the old justice of the peace who made his decisions upon the basis that there are three sides to every lawsuit—the plaintiff's side, the defendant's side and the right side, which is the middle."<sup>9</sup> A second remarkable and coincidental computation: the lowest value assigned to the stock by an expert witness was \$150 per share; the highest value adopted by an expert witness was \$225 per share. The sum of the lowest and highest opinion was \$375, the "value" chosen by the court!

If uncertainty in the valuation of the stock of a closely-held corporation is one of the facts of life, it must nevertheless be admitted that neither the Commissioner nor the courts have done much to make this fact easier to live with.

---

(g) Sales of the stock and the size of the block of stock to be valued.

(h) The market price of stocks of corporations engaged in the same or a similar line of business which are listed on an exchange."

"SEC. 7. AVERAGE OF FACTORS.

Because valuations cannot be made on the basis of a prescribed formula, there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason no useful purpose is served by taking an average of several factors. . . ." *Id.* at 193.

8. 237 F.2d 729 (8th Cir. 1956).

9. *Id.* at 734.

*Restrictions on Sale*

At first blush, one would think that if the buy-sell agreement were only to apply at the death of either party, it would be sufficient for valuation purposes. As a practical matter, an interest in a closely-held corporation, especially a minority interest, has very little market value, so that its sale except to the co-stockholder is in practical effect restricted. Many attorneys are fully familiar with the loud wails which greet the suggestion that the co-stockholders agree on a right of first refusal; the client recognizes accurately the dampening and restrictive effect of the right of first refusal on ability to sell, on the market—if any—for the shares, and on the price of the shares. Yet the Treasury has publicly announced that it will generally refuse to recognize for the purpose of valuing the shares for federal estate tax any buy-sell agreement which does not restrict the sale of the shares during lifetime as well as at death. In his proposed regulations the Commissioner has said:

*"Ordinarily, no effect will be given to an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his life. Such is the effect of an option or contract to purchase whatever shares of stock the decedent may own at the time of his death, or an agreement amounting only to a right of first refusal during the decedent's life."*<sup>10</sup>

The result, if the tax practitioner permits the tax tail to wag the buy-sell dog, is the intrusion of provisions in the agreement restricting the sale during lifetime, when counsel, along with his client, would certainly prefer the power to negotiate at arm's length during his lifetime, leaving the automatic purchase and sale to his estate.

*Funding the Purchase*

It has long been believed or assumed—in the maze of literature in this field it is sometimes difficult to distinguish between assumptions and fact—that the purchase by a corporation of insurance upon the life of an officer (even if he was also a stockholder) is a proper corporate business purpose.<sup>11</sup> The corporation had the choice of making the employee or his estate a beneficiary of the policy, in which event the premiums paid would be deductible by the corporation, and includable in the income of the employee, in the absence of some qualified deferred compen-

10. Proposed Regulations § 20.2031-2(h), 21 Fed. Reg. 7850, 7867 (1956). (Emphasis added.)

11. *Emeloid Co. v. Commissioner*, 189 F.2d 230 (3d Cir. 1951). The precise holding in this case (which has been viewed as a broad tax approval of stock redemption agreements) was that sums borrowed in 1942 to pay premiums on insurance policies on the lives of officers were entitled to be treated as "borrowed invested capital" during 1944 under the Excess Profits Tax Act of 1940, 26 U.S.C.A. § 719, repealed by 59 Stat. 563 (1945). "Key man" insurance was held to be a proper corporate business purpose.



sation arrangement, or on the other hand, making the corporation the beneficiary, in which case the corporation was not entitled to a deduction for the premiums paid,<sup>12</sup> the purchase of the insurance policy being treated like the investment of the corporate funds in any other asset, and no income tax consequences would result to the individual officer-stockholders whose lives were being insured. If the purchase of the insurance policy was a proper corporate business purpose, as a means of replacing the asset to the corporation which would be lost on the death of the officer, it was a logical step, it was believed, to use the proceeds of such an insurance policy for the purchase of the officer-stockholder's shares pursuant to a buy-sell agreement.<sup>13</sup> Yet just so fundamental an arrangement was exploded or at least badly mauled by the Tax Court in the *Henry E. Prunier* case,<sup>14</sup> where it was decided, over the dissent of three judges who protested that the "... result seems . . . to destroy the symmetry of the pattern now designed for taxing corporate life insurance,"<sup>15</sup> that since the proceeds of insurance would be automatically applied to the purchase of the stock held by the decedent under the buy-sell agreement, the corporation was neither directly nor indirectly the beneficiary of the policies; rather, the policies were taken out and the agreement entered into for the benefit of the stockholders. The court therefore decided that the premiums paid by the corporation on the policies to fund the buy-sell agreement were includable in the taxable income of each of the corporate stockholders. While it is possible to reason away the decision on its particular facts,<sup>16</sup> and it might be possible to avoid its impact by a proper provision as to the right to change the beneficiary, it is not possible to whistle away the language of the court, which strikes at a fundamental aspect of the funding of these arrangements.

---

12. Int. Rev. Code of 1954, § 264(a)(1).

13. *Emeloid Co. v. Commissioner*, 189 F.2d 230 (3d Cir. 1951) may be responsible for the optimism of the tax planners. There the court, after first finding all that it needed to hold (that the initial purchase of the policies in 1942 as key man insurance meant the loans incurred on the purchase were proper investments for excess profits tax purposes in 1944), went on to add that the use of the insurance policies to fund a buy-sell-redemption agreement entered into in 1946 not only did not make the purchase of the policies, proper when made, now improper, but in itself was an "appropriate business reason"—to provide for continuity in the management and policies of the company. *Id.* at 234.

14. 28 T.C. No. 4 (April 12, 1957).

15. *Ibid.*

16. For a labor of love on this score, see Lawthers, *Prunier Offers No Threat to a Sound Insured Buyout Plan*, J. Taxation, July 1957, p. 2. See also *Doran v. Commissioner*, CCH 1957 Stand. Fed. Tax Rep. (57-1 U.S.T.C.) ¶ 9822 (9th Cir. July 9, 1957), where the court held that the redemption was not a taxable dividend on the ground that the policies had been deposited with trustees and the corporation, even though it had paid the premiums, retained no incidents of ownership.

*Redemption v. Cross-Purchase Agreement*

If the corporation had not been prosperous the ghost of a taxable dividend might not be present. But the Lincoln Specialty store, the subject of our fable, was prosperous; its earned surplus was at least equal to the purchase price called for by the buy-sell agreement. In these circumstances there is a real danger that moneys paid out by the corporation to Silas' estate, whether or not derived from the proceeds of the insurance policies on Silas' life, would be held to be a taxable dividend to Silas' estate or to Thomas or to both of them, income taxable at ordinary graduated rates, and not as capital gains. It is a notion which many general practitioners miss, and which cannot be overstressed, that payment of moneys by a corporation on a redemption of stock which does not as a practical matter change the essential relationship between the shareholders and the corporation is generally considered equivalent to and taxable as a dividend to the extent of the accumulated earnings and profits (earned surplus) of the corporation.<sup>17</sup> Suppose, for example, that Silas during his lifetime owned all 1500 shares of the issued and outstanding capital stock of the Lincoln Specialty Store, Inc., which had an earned surplus of \$500,000 and cash in that amount. Suppose further that the corporation redeemed 500 of his 1,500 shares and paid him \$500,000 on the redemption. True, the form of the transaction is a sale under which he surrenders certain pieces of paper called stock certificates and receives cash as the purchase price thereof; but obviously his relationship to the corporation has not essentially changed. If the corporation had declared the \$500,000 out to him as a dividend, the situation would not have been essentially different. Prior to the dividend he was the owner of all shares of the capital stock. After the dividend he was the owner of all shares of the capital stock. The only change has been in the passage of \$500,000 from the corporate till to Silas' pocket. So with the redemption of his 500 shares: prior to the redemption he was the owner of all the corporation's outstanding capital stock; after the redemption he continued to be the owner of all the corporation's capital stock. The only difference is that \$500,000 has passed out of the corporate till into his hands and that \$500,000 is clearly taxable as a dividend.<sup>18</sup>

The shocking change, one which has caused an eruption in the literature and a proliferation of articles on the subject, is in the situation where Silas is not the sole stockholder, but as in our fable owns less than all, and on his death his entire interest in the corporation is

---

17. See Rev. Rul. 56-521, 1956 Int. Rev. Bull. No. 43, at 11.

18. See Int. Rev. Code of 1954, §§ 301, 302(b)(1); T.D. 6152, § 1.302-2(b), 1955-2 Cum. Bull. 61, 74.

redeemed. Prior to the 1939 Code it had been held that the termination of the interest of a particular stockholder, including a deceased stockholder, if it was a complete termination, was to be treated as the sale of stock and no part of the payment for the stock would be treated as the distribution of a taxable dividend, even if the shareholders remaining in the corporation were all members of the decedent's family.<sup>19</sup> Even under the 1954 Code a complete termination of Silas' interest during his life would, under certain conditions which can be complied with since they are relatively definite and understandable, be considered a sale or exchange of the stock for cash and would not result in a taxable dividend.<sup>20</sup> However, the situation is not the same on Silas' death. For here, if the remaining stockholder, Thomas, is a beneficiary of Silas' estate (remember the gift of the family photographic album), then Silas' estate is treated as owning Thomas' shares (despite his stepmother) and Thomas is treated as owning the shares owned by Silas' estate. The result is that by the application of 1954 Code section 302(b)(3) and the attribution rules of section 318, redemption of the stock owned by Silas is not a complete termination of interest; and unless some other provisions are applicable, payment of the purchase price to Silas' estate may be treated in whole or in part as a taxable dividend.<sup>21</sup> The moral which is immediately suggested, but which may be immediately rejected, is that the only safe advice which one can give to a client is that if he desires to enter into a buy and sell agreement with his son, he should leave him nothing in his will!

If the payment of the stock may be a dividend, to whom is it a dividend? One would expect that it would be treated as a dividend to Silas' estate, for it is the executor who is receiving the purchase price. But remember that corporate funds are being used for the ultimate benefit of the surviving stockholder, Thomas; and the *Louis H. Zipp* decision,<sup>22</sup>

---

19. Under the 1939 Code, Rev. Rul. 54-458, 1954-2 Cum. Bull. 167 provided that "... a cancellation or redemption by a corporation of all of the stock of a particular shareholder so that the shareholder ceases to be interested in the affairs of the corporation, does not effect a distribution of a taxable dividend." *Id.*, 1954-2 Cum. Bull. at 168. There were some protests of the Treasury as to the application of the regulation in family situations where the seller continued in fact to be "interested." See *Estate of Ira F. Searle*, P-H 1950 Tax Ct. Mem. Dec. ¶ 50261; Winton & Hoffman, A Case Study of Stock Redemptions Under Sections 302 and 318 of the New Code, 10 Tax L. Rev. 363, 365 (1955), and cases there cited.

20. Int. Rev. Code of 1954, §§ 302(b)(3), (c)(2); Rev. Rul. 56-556, 1956 Int. Rev. Bull. No. 45, at 6. In essence, the father must retain no interest in the corporation for 10 years (the "look forward") nor have made a gift to members of his immediate family within the 10 years prior to the redemption (the "look back").

21. Rev. Rul. 55-515, 1955-2 Cum. Bull. 222.

22. 28 T.C. No. 32 (April 30, 1957).

a somewhat fuzzy case under the influence of the notorious *Casale* decision,<sup>23</sup> gives us the disquieting news that the payment of the \$500,000 purchase price may be a dividend to Thomas!

### *A Nightmare*

But the unkindest cut of all was dealt not by the Commissioner, not by the Tax Court, nor even by its federal superiors,<sup>24</sup> but by the New York appellate division in *In the Matter of Galewitz*.<sup>25</sup> For it is this case that gives Thomas the unwelcome news that, as purchaser under the buy and sell agreement, he is acquiring not only the stock but the estate tax liability attributable to his bargain.

The *Galewitz* case is an estate planner's nightmare. The Clinton Paper Corporation, in which the decedent Jacob Galewitz had a two-thirds stock interest, constituted the major asset of the estate. Jacob had given one-third of the outstanding shares to his son in 1933 when the son became twenty-one. The son continued to be active in the father's business all of his adult life. In 1947, when the son was thirty-five and had been continuously employed by the business and had continuously been a stockholder for fourteen years (he became the actual operating head of the business after the father's death), the father and son entered into a written agreement under which, as described by the appellate division:

"... if either died, the survivor was to have the option to purchase the shares of the other, at a price determined by a court-appointed accountant. The price was to be determined by valuation of the corporate assets as of the time of death, under a formula which used book values and liberally discounted various classes of assets. Moreover, the buyer was permitted to pay the balance of the purchase price, by monthly installments with interest at 4%, over a period of 10 years, after a down payment of 20%."<sup>26</sup>

The father died three years later, in 1950, leaving a will creating a trust for his second wife with remainders and bequests in which both the children of the first marriage and children of the second marriage participated.

If the purpose of the buy-sell agreement is, as has been suggested, to effect a smooth transition of stock ownership and control on the death of a co-stockholder, the *Galewitz* contract failed miserably. Its principal fruit so far has been litigation both in the Treasury Department and in

---

23. *Oreste Casale*, 26 T.C. 1020 (1956).

24. Consider the views of the Tax Court on its relationship to the courts of appeal: *Arthur L. Lawrence*, 27 T.C. No. 82 (January 25, 1957), where the court said: "... if still of the opinion that its original result was right, a court of national jurisdiction to avoid confusion should follow its own honest beliefs until the Supreme Court decides the point."

25. 3 A.D.2d 280, 160 N.Y.S.2d 564 (1st Dep't 1957).

26. *Id.* at 282-83, 160 N.Y.S.2d at 569.

the surrogate and supreme courts. None of this litigation has terminated as of this writing. The conflicting interests of the son, the executors of the estate, the widow, and the special guardian for the infant children of the second marriage (who really seized his opportunity), were "embattled," as Justice Breitel reported, "in various combinations." Among the issues and questions raised in the seven years since the decedent's death are: (a) the domicile of the decedent for the purposes of probate; (b) that the contract, which contained no restrictions on the sale during lifetime, was invalid as an attempted testamentary instrument;<sup>27</sup> (c) that the contract was invalid because the option price was less than the actual value of the shares, *i.e.*, inadequacy of the consideration;<sup>28</sup> (d) that the contract, since it resulted in the acquisition by the son at a bargain of the most substantial asset of the estate, was invalid as in fraud of the rights of the widow under section 18 of the Decedent Estate Law;<sup>29</sup> (e) whether the earnings of the corporation during the period of litigation allocable to the various shares (which amounted to \$385,000) belonged to the son or were required to be added to the purchase price of the stock;<sup>30</sup> (f) whether the independent appraiser appointed by the court correctly valued a second mortgage at its face value rather than at cost in determining the "book value" called for by the buy-out agreement; (g) whether in determining "book value" the appraiser should properly have deducted a reserve for accrued income and state franchise taxes which had not yet become payable;<sup>31</sup> (h) where the formula in the buy-sell agreement called for the use of assessed values as the method of valuation of real property, whether the city or county valuations should be accepted;<sup>32</sup> (i) and finally, and most important for our purposes, whether the son, as a person interested in the gross tax estate under section 124 of the Decedent Estate Law was required to pay the portion of the federal estate taxes attributable to his interest, specifically the additional \$350,000 in federal estate taxes resulting from the valuation by the Director of Internal Revenue of the stock at \$1,345,000 instead of the \$600,000 called for by the buy-sell agreement.<sup>33</sup>

On this last issue, Surrogate Collins took the orthodox view, one which might reasonably be expected of a judge who has had some confidence in

---

27. In the Matter of Galewitz, 206 Misc. 218, 221, 132 N.Y.S.2d 297, 299 (Surr. Ct. 1954), *aff'd*, 285 App. Div. 947, 139 N.Y.S.2d 897, leave to appeal denied, 285 App. Div. 1049, 141 N.Y.S.2d 501 (1st Dep't 1955).

28. *Id.* at 223, 132 N.Y.S.2d at 301.

29. *Id.* at 223, 132 N.Y.S.2d at 301-02.

30. In the Matter of Galewitz, 3 Misc. 2d 197, 148 N.Y.S.2d 823 (Surr. Ct. 1955).

31. *Id.* at 205, 148 N.Y.S.2d at 831.

32. *Id.* at 207, 148 N.Y.S.2d at 833.

33. *Id.* at 202-03, 148 N.Y.S.2d at 828-29.

the substantive law. Samuel, the son, as the holder of a contractual right and obligation to acquire the stock was a "creditor," not a beneficiary and was not required to contribute to the estate taxes. Said Surrogate Collins:

"When Samuel Galewitz agreed with his father to permit the survivor to purchase the stock of the first to die each became vested with inchoate rights as a creditor of the other's estate. As events transpired it was Samuel whose rights as a creditor have been perfected for it is now the law of the case that he is entitled to compel the performance of his father's promise and to a judgment against the latter's estate. As a creditor the law imposes no obligation . . . for estate taxes and he takes the stock free of any such charge. . . . The tax burden is apportioned only among the persons 'interested in the gross tax estate' (Decedent Estate Law, § 124, subd. 1) and by definition, a creditor is not included within that category (Surrogate's Ct. Act, § 314, subd. 10). The court holds accordingly that Samuel Galewitz will not be required as a creditor of the estate to contribute to the additional tax attributable to the excess in the value of the stock as determined by the Director of Internal Revenue as against the purchase price fixed in the agreement."<sup>34</sup>

The surrogate was not heedless of the growing monster, the competing tax law:

"The determination here made was not the result of a failure to recognize its possible tax consequence to the estate though that is a factor which the court cannot allow to influence its decision. . . ."<sup>35</sup>

The surrogate took the traditional view that a contract had been made, a contract which was valid. The purchaser under the contract had a creditor's claim which he was entitled to enforce; the contract was not testamentary in character and the son, who was not, with respect to the stock in Clinton Paper Company, a beneficiary of the estate, could not be charged with the tax which arose, even though the tax resulted from or was attributable to the value of his bargain.<sup>36</sup>

But Justice Breitell, in writing the unanimous opinion reversing the surrogate on this point in the appellate division, was not so reluctant to adopt the perspective of the tax law. He directed that the decree of specific performance to the son be conditioned upon the assurance from the son, as buyer, that when the estate tax was finally assessed it would be paid by him. The appellate division held that the son was not a creditor within the meaning of section 124 of the Decedent Estate Law, and accepted the argument of the widow and special guardian for the

---

34. *Ibid.*

35. *Id.* at 203, 148 N.Y.S.2d at 829.

36. The court did, however, make a sly but hopeful suggestion to the Internal Revenue Service which apparently has not been heeded: "There is, however, a line of authority which suggests that the determination of the Director of Internal Revenue fixing the so-called market price instead of the option price as the basis for the assessment of the tax is not unassailable in view of the fact that this court has decreed specific performance of the agreement." *Ibid.*

children that the tax deficiency was solely the product of the difference in value of the Clinton shares from the option formula price, and, therefore, the buyer, as the transferee of a benefit from the estate in excess of the price, should bear the tax burden thereon. Justice Breitell reached this conclusion primarily by reference to the New York Tax Law which includes in the gross estate "... any interest ... of which the decedent has at any time made a transfer by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, except in case of a *bona fide sale for an adequate and full consideration for money or money's worth*."<sup>37</sup>

The crux of Judge Breitell's argument is the following observation:

"The point, put still another way, is that while the option is valid in contract law, its status tax-wise is not that of a bona fide sale contract, but of a transfer, part-sale, and part-gift. As to the part-gift the tax is imposed, and, therefore, apportioned to the part-donee. (*Matter of Cory*, 177 App. Div. 871, affd. 221 N.Y. 612, *supra*; *Matter of Orvis*, 223 N.Y. 1, *supra*.)"<sup>38</sup>

Things used to be easier for the followers of jurisprudence. A contract was either a contract or not a contract; a divorce was either effective or not effective; a wife was either a wife or not a wife; and a transfer was either a gift or a sale. But apparently there is an intellectual appeal in a divisible concept; if a divorce can be recognized for one purpose but not for another,<sup>39</sup> if a wife can be entitled to board but not to bed, why not a transferee who is a purchaser for one purpose and a donee for another?

I suspect, however, that this is not the whole answer. Consider the language of the Treasury Department's proposed regulations on the effect which will be given for valuation for federal estate tax purposes to a buy-sell agreement. The full regulation is as follows:

"(h) *Securities subject to an option or contract to purchase.* Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. *Ordinarily, no effect will be given to an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his life.* Such is the effect of an option or contract to purchase whatever shares of stock the decedent may own at the time of his death, or an agreement amounting only to a right of first refusal during the decedent's life. Even though the decedent's right to dispose of the underlying securities during his life is restricted, if full and adequate consideration in money or

37. N.Y. Tax Law § 249-b(c). (Emphasis added.)

38. 3 A.D.2d at 293-94, 160 N.Y.S.2d at 579. Both the Cory case and the Orvis case cited in the court's opinion were estate tax decisions; neither dealt with charging the tax under N.Y. Deced. Est. Law § 124.

39. *Estin v. Estin*, 334 U.S. 541 (1948).

money's worth was not given for the option or contract, the option or contract price will be disregarded in determining the value of the securities. An agreement will ordinarily be presumed to have been entered into for full and adequate consideration in money or money's worth *if it was arrived at as a result of arm's length bargaining between strangers*. However, this presumption does not apply if the agreement is entered into by the decedent and those who are, directly or indirectly, the natural object of his bounty, as for example, an agreement entered into by the decedent and a corporation controlled by the decedent and his family."<sup>40</sup>

Note that the Service proposes to give weight to the buy-sell agreement even if it restricts sale during life only "if it was arrived at as a result of arm's length bargaining between strangers." One may ask facetiously how co-stockholders in a closely-held corporation could ever be "strangers." But as to contracts entered into like that in the *Galewitz* case and the contract between Silas and Thomas in our fable the pronouncement of the Treasury is discouraging. "Full and adequate consideration in money or money's worth" must be given for the "option or the contract" and if the promisee is a natural object of the decedent's bounty the whole agreement may fall flat on its cover.

There are substantial echoes of the Estate Tax Regulations in Justice Breitell's opinion in the *Galewitz* case. It has long been a favorite tactic of counsel in the tax-estate-corporate field to argue that local law must control tax consequences; that if a contract produces substantive rights in the state courts, those rights must be recognized in determining to whom and how income shall be taxed. Yet the federal courts and, of course, the Commissioner have generally maintained independence, insisting that tax consequences must be determined by federal policy and will not, in the absence of specific adversary proceedings on the point at issue, be controlled by state statutes or decisions.<sup>41</sup> Yet in the *Galewitz* case we find a judge in a state court insisting that the legal obligations of the participants in the distribution of an estate must be determined by the tax consequences, and that in effect tax principle must control substantive law. One is tempted to comment that if this is not a case of man bites dog, it is certainly one of life imitating art! To be sure, one could argue that under Justice Breitell's decision, as he warned at the outset, "... rules of law are to be applied, and equities, as they appear in the record, are to be accorded recognition."<sup>42</sup> The fact that a charge of the additional estate tax to the executor "... would diminish the net estate to a tiny fraction of its original size"<sup>43</sup> is not to be sneezed

40. See note 10 *supra*. (Emphasis, except for heading, added.)

41. E.g., *Morrissey v. Commissioner*, 296 U.S. 344 (1935); see Colowick, *The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case*, 12 *Tax L. Rev.* 213 (1957).

42. 3 A.D.2d at 284, 160 N.Y.S.2d at 571.

43. *Id.* at 291, 160 N.Y.S.2d at 576.



at. Moreover, the rather liberal provisions in the option contract, considered *post hoc*, influence the decision. Some of the assets were to be discounted in the formula, the use of the value for local tax purposes was rather unusual, and the substantial deferment of the purchase price with a provision for instalment payments might have seemed to be beyond the scope of an arm's length transaction. Yet it is now not uncommon for instalment transactions of this kind to be made, especially where the purchaser has no independent estate and the seller is willing to establish an arrangement which will permit the purchaser to use the earnings of the corporation or business entity being acquired as a means of paying off the purchase price. Close corporations are not easy to market and this may very often be the only way in which the transaction can be effected.

It should be noted that neither the appellate division nor the Treasury Department seems to give any consideration to the question of the date as of which the adequacy of the consideration is to be determined. It is one thing to say that the bargain granted the son at the time the contract was entered into (in 1947) was obviously so great as to be donative in character, and another to say that the contract for a full and adequate consideration when entered into became inadequate as a result of events at the date of the decedent's death. There is no finding in any of the published opinions in the *Galewitz* case that the contract entered into in 1947 was not a fair contract for full consideration in the light of the valuation facts as they then stood;<sup>44</sup> and such a finding, it seems, should be essential to a determination that the contract shall be given no effect for estate tax or estate distribution purposes.<sup>45</sup>

There is need for a thorough reexamination of the concept adopted in the proposed Estate Tax Regulations and implicit in the opinion in the *Galewitz* case that an agreement which does not restrict the sale of the stock during life shall be given no effect for estate tax purposes. This notion first found acceptance in the Tax Court in cases where the promisee was clearly a "natural object of the seller's bounty" and in which the consideration to be paid or purchase price was so clearly nominal as to make the arrangement obviously testamentary and dona-

---

44. One might also add this question about the *Galewitz* case: suppose that the son had predeceased the father? Could the argument still be made that the sale of the son's share to the father, pursuant to the buy-sell agreement, was part sale, part gift?

45. In the *Matter of Orvis*, 223 N.Y. 1, 119 N.E. 88 (1918), cited by the appellate division in the *Galewitz* case, stressed the following: "In all cases in which the value of the consideration for the property transferred, under statutory conditions, is so disproportionately less than the value of the property transferred that the transfer is, in the light of reason or of ordinary intelligence and judgment, beneficial and donative, the transfer is taxable." *Id.* at 8, 119 N.E. at 89.

tive in character.<sup>46</sup> In his proposed regulations the Commissioner purports to strike down not only those where the parties are members of the same family, but any agreement, even if made between "strangers," if there is not a restriction on sale during life; and, in the view of the proposed regulations, a first refusal option is not a sufficient restriction. The theory that such an arrangement operates only at death and is therefore testamentary in character undoubtedly proceeds along these lines: if the contract price is \$600 per share but the seller is free to sell to anyone else during his lifetime, he could, theoretically, the moment before death, sell to someone else at the market value, say \$1200, and his power to defeat the buy-sell agreement by such a sale makes the arrangement one which is intended to take effect at death, taxable as if it were a gift intended to take effect at death. But this theory forgets to take into account the circumstances surrounding the execution of the contract.<sup>47</sup> If the purchase price (either absolute or as a result of a formula) would have been a fair and reasonable price at the time of the execution of the contract, does it become unreasonable and is it transmuted from sale into gift merely by reason of the subsequent increase in value or the passage of time? Since man cannot ordinarily control the moment of his death, it is difficult to accept the notion that the man who thinks he is making a fair bargain today is making a gift tomorrow. When there is added to the facts a right of first refusal in the usual form, a requirement that the offer be bona fide, that the terms of the offer must be disclosed, and that the offeree must be given a reasonable time in which to purchase, then the buy-sell arrangement in its total effect certainly restricts and reduces the value of the shares immediately. If there is evidence in the form of appraisal,<sup>48</sup> in the way in which the formula is prepared, to indicate the parties attempted to arrive at a price which would be reasonable on an arm's-length basis, if in addition the seller must first offer the stock to the other party to the contract during his lifetime, it is submitted that the

---

46. E.g., *Claire Giannini Hoffman*, 2 T.C. 1160 (1943) where the court said: "In other words, we are of the opinion that while a bona fide contract, based upon adequate consideration, to sell property for less than its value may fix the value of the property for the purposes of the estate tax, a mere gratuitous promise to permit some favored individual, particularly the natural object of the bounty of the promisor, to purchase it at a grossly inadequate price can have no such effect." *Id.* at 1179.

47. Each of the parties who signed the agreement discussed in *In the Matter of Cory*, 177 App. Div. 871, 164 N.Y. Supp. 95 (1st Dep't 1917), cited by the appellate division in the *Galewitz* case, executed, on the date the agreement was signed, identical wills confirming the agreement and authorizing the executors to offset a bequest in the will with a purchase price required to be paid by the survivor.

48. The Proposed Regulations § 20.2031-3, 21 Fed. Reg. 7850, 7867 (1956) give some hint of this, although the valuation provisions refer specifically only to "the applicable valuation date," presumably date of death or one year thereafter.

contract price should be respected by the Internal Revenue Service and the courts in fixing the valuation for estate tax purposes.<sup>49</sup> This is especially true, it seems, where a substantial period of time has elapsed between the execution of the contract and the death of the party; where there is evidence that the purchaser in effect gave consideration in the form of participation in the business; where the facts indicate that seller and buyer were dealing on a businesslike basis and the circumstances suggest that no gift in contemplation of death and no bargain transfer was intended. The strictures of the Internal Revenue Service would literally apply, for example, whether Thomas was Silas' favored son or his banished prodigal, whether his interests were adverse to those of the beneficiaries of the estate and members of the family or coincided with them, and whether Silas was in fine health or in an oxygen tent when he signed the agreement, whether the purchase or formula price was ninety per cent or ten per cent of the real value. Laymen understandably find it hard to accept the idea that if the estate receives only \$600 per share that it nevertheless must pay a tax on \$1,000. Striking the sentence from the proposed Estate Tax Regulations which suggests that a right of first refusal is not a sufficient restriction on sale would go far to accord with what are the reasonable and practical equities of the matter.

#### PROVIDING FUNDS FOR THE BUYER

If the views of the Commissioner and the courts on the effect to be given buy-sell arrangements in the valuation of the decedent's stock seem to have gone beyond reasonable bounds, the recent trend toward a more sophisticated view of insurance arrangements seems to be another matter. While the lines are often blurred, there are some signs of a return to the notion that the choice of business form, corporation, partnership or proprietorship, should turn on considerations other than tax factors. Lawyers should welcome any such development, even if particular taxpayers and particular tax arrangements smite their shins in the process! In the *Oreste Casale* case,<sup>50</sup> which has generated a considerable amount of heat, the taxpayer's ninety-eight per cent-owned corporation purchased a retirement annuity for him payable at age sixty-five. In form, the documents in the record followed the route of a deferred payment arrangement, with the corporation entering into a contract to pay him an annuity on his retirement, then independently purchasing an insurance policy annuity from a life insurance company, and arrang-

49. It would appear that in the Tax Court even a complete restriction on sale during life, if combined with a formula that arbitrarily excludes good will, will not be sufficient to make the agreement effective to fix estate tax valuation. Compare *Estate of George Marshall Trammell*, 18 T.C. 662 (1952), with *Estate of Lionel Weil*, 22 T.C. 1267 (1954).

50. 26 T.C. 1020 (1956).

ing matters so that upon retirement the policy would be paid to the company, which would then effect payment pursuant to the compensation agreement. The taxpayer was given the right to designate the beneficiaries of death benefits, of retirement income benefits, and the right to change any such designation. Conditions were imposed similar to those which the corporation would reasonably impose on any executive to induce him to remain with the company and serve its purposes faithfully: the right to receive the pension payments was "forfeitable" in the event he left the employ of the corporation prior to attaining age sixty-five or accepted employment from a competitor after retirement, "without the consent" of the corporation. But the Tax Court, keeping its eye transfixed on the fact that Casale owned ninety-eight per cent of the stock of the corporation, quite properly treated the contingencies as more apparent than real, and the factual situation as no different from the case of a corporation that caused the benefits under the policy to be payable directly to the taxpayer-stockholder and the annual premiums to be paid each year by the corporation for the stockholder's benefit. The court held that the annual premiums constituted income to Casale, in the years in which such premium payments were made. The taxpayer's substantially wholly-owned corporation in this situation was merely a conduit for the benefits of the insurance policy.

From this case it is only a short step to the *Henry E. Prunier* case, where the same court held that premiums paid by a corporation on insurance policies which were specifically directed to be used to purchase stock of a deceased stockholder for the benefit of the survivor, also constituted income to the respective stockholders in the years in which such premiums were paid. The shock came from the fact that while the *Casale* case was obviously an instance of a taxpayer dealing with himself, the *Prunier* case dealt with what had been considered to be a long-established and protected custom of funding a buy-sell arrangement through life insurance purchased by the corporation, with the corporation being the substantial owner of the policies. If the same arrangement had been adopted by two partners, rather than two stockholders, the premiums paid by one partner on the life insurance on the life of the other would not be deductible; the cost of such premium would not be treated as an ordinary or necessary business expense, and each payment regarded as inuring to the benefit of the partner making it.<sup>51</sup> The result should not be substantially different where the corporation acts as a conduit for the proceeds of the policies through the repurchase of the stock of the decedent.

---

51. Ernest J. Keefe, 15 T.C. 947 (1950).

The federal courts, in a temporarily liberal mood, once held that the investment by a corporation in life insurance on the life of a principal officer constituted a transaction with a proper business purpose, so that the cost of the policies could be included in invested capital (technically loans made in order to purchase the policies) for excess profits tax purposes.<sup>52</sup> "The continuity of harmonious management," said the court, was an appropriate enough business purpose to permit this result. From this slim reed, insurance companies and tax planners have built a vast structure which the *Casale* and *Prunier* cases threaten to blow away. For if, as seems obvious in many cases, the proceeds of the insurance policies will be used directly or indirectly to eliminate immediately the stockholdings of the decedent—not for the purpose of tiding the corporation over while new management can be obtained, or in some other way to compensate the corporation for the loss of the officer-stockholder—it is hard to refute the argument that the purchase of the premiums is intended for the benefit of the stockholders, inures directly to them, and should be taxable to them as each premium is paid, at least where the corporation is closely held and controlled by the persons for whose benefit the program is adopted. It is difficult to find much substance in the argument by the court of appeals in the *Emeloid* case,<sup>53</sup> swallowed wholeheartedly by some authorities,<sup>54</sup> that the corporate business purpose, as distinguished from the stockholder purpose, is assured by the fact that the proceeds of insurance payable to a corporation are first available to the latter's creditors before they can be used to fund a redemption agreement. (The question arises whether this would be so if the insurance proceeds were pledged to secure the redemption obligation by a deposit with a trustee.)<sup>54a</sup> In the first place, the availability of the proceeds is momentary only. In the second place, the only instance in which this fact would have utility is a situation in which the corporation is insolvent or nearly so. In such event, under most corporate statutes, the performance of the redemption agreement by the officers or directors would be a criminal act, since the redemption would be made out of capital rather than surplus.<sup>55</sup> It seems, therefore, that the significance of the availability of the proceeds for general creditors has been rather exaggerated. The existence of the fact, of course, points up one of the basic difficulties in the stock redemption agreement from the point of

---

52. *Emeloid Co. v. Commissioner*, 189 F.2d 230 (3d Cir. 1951).

53. *Ibid.*

54. See Friedman, *Buy and Sell Agreements: A Review and a New Look*, N.Y.U. 15th Inst. on Fed. Tax. 1053 (1957).

54a. Compare *Doran v. Commissioner*, CCH 1957 Stand. Fed. Tax Rep. (57-1 U.S.T.C.) ¶ 9822 (9th Cir. July 9, 1957), with *Sanders v. Fox*, 149 F. Supp. 942 (D. Utah 1957).

55. E.g., N.Y. Pen. Law § 664(5).

view of the selling stockholder. But of course even individuals have creditor and bankruptcy problems.<sup>56</sup>

The difficulty with the assumption that such arrangement is primarily of benefit to the corporation is highlighted when minority stockholders are present. This was the situation in the *Prunier* case, although the court did not advert to it. If the premiums are paid by the corporation, thus constituting an application of corporate funds, but the proceeds are required to be paid to the departing stockholder or his estate, and if the corporation receives no substantial consideration for the arrangement (and in many cases through inadvertence of counsel is not even a party to the agreement), it is hard to see why such a payment does not constitute a preferential dividend to the departing stockholder. It is expected that some day a minority stockholder will move in on such an arrangement in a derivative suit and require the board of directors of the corporation to refuse to make payment of the proceeds of the policy on the ground that such would be a misuse of the investment. Obviously, wherever there is a minority interest, the agreement should be approved by the stockholders and should be made a part of the employment agreement of the officer-stockholder, so that this argument can not be supported. Here again, the tax dangers in any such arrangement may make such a solution difficult, because the Commissioner could argue that to some extent the payment of the proceeds was additional compensation.

We move now to the situation which exists on the payment of the proceeds of the insurance policies to the corporation. A further difficulty is encountered. If the buy-out agreement is not one of those which receives the Commissioner's stamp of approval, consideration must also be given to the effect which the receipt of the insurance proceeds by the corporation has on the valuation of the shares for federal estate tax purposes. If the corporation owns a policy on the life of Silas which the moment before death has a cash surrender value of \$25,000, but the moment after death becomes worth \$50,000, must the \$25,000 increment be added to the valuation of the shares? One would think, that since, as has been pointed out, for the purpose of determining the validity of the buy-sell agreement for tax purposes, the Commissioner considers the restrictions existing at the moment *before* death, the value of the insurance policy should also be determined as of that time. But no, consistency is not deemed a virtue of Commissioners of Internal Revenue, and the proposed Estate Tax Regulations rule as follows:

---

<sup>56</sup> The further suggestion of the court in the *Emeloid* case that the business purpose of the transaction is supported by the ability of the corporation to resell the shares redeemed is highly unrealistic. Increase in authorized stock is relatively inexpensive and (where there are no other shareholders to dissent) easy to accomplish, and the power to resell shares of stock in a closely-held corporation, especially a minority interest, is frequently of doubtful value.

"(6) Life insurance policies frequently form a part of arrangements for the purchase of partnership interests or corporate shares from a decedent's estate. If such an arrangement is a binding agreement for full and adequate consideration in money or money's worth entered into in good faith and at arm's length providing for the use of proceeds of insurance on the decedent's life for the purchase of his partnership interest or corporate shares, the value of the interest or shares (*as affected by the agreement*) and not the value of the insurance, is included in the decedent's gross estate. *However, if the insurance is owned by or payable to the partnership or corporation, or a trust created by it or for its benefit, the proceeds of insurance are considered as an asset of the partnership or corporation for the purposes of first, determining whether the agreement was supported by full and adequate consideration in money or money's worth, and second, determining the value of the decedent's interest or shares if the agreement is not considered to have been entered into in good faith and at arm's length.*"<sup>57</sup>

It will be noted, then, that the increment in the value of the insurance will be included in "determining the value of the decedent's interest or shares." The solution which some have suggested is that the corporation take out more insurance to cover the additional estate tax which will result from the increase in the value of the shares in the federal estate tax return. (More insurance will produce a higher valuation, which will produce a higher estate tax, which will require more insurance.) It is difficult to see, if the buy-sell agreement does not require the proceeds to be applied to or paid to the departing stockholder or his estate, how the increment can be included in the taxable estate when all that is paid out is the formula price, and adding the proceeds to the value at death in the face of the agreement seems to add insult to injury!

Again there will be a conflict between the tax objective, the limitation of estate taxes, and the claim of the beneficiaries. Since the stockholder's death brings about the increment in value of the corporation, the stockholder's estate should be entitled to that increment. This argument will be difficult to refute, and the pressures to include some portion or all of the insurance increment in the formula price will be difficult to resist, especially as counsel will have to admit frankly that under the proposed regulation the agent will usually attempt to include the increment as part of the valuation of the shares.

#### THE DIVIDEND DANGER

We have previously discussed the general effect of the provisions in sections 302 and 318 of the Code which basically treat the stock owned by the estate (the executor) and stock owned by the beneficiary of the estate, or any beneficiary of the estate, as held by the same person.<sup>58</sup>

---

57. Proposed Regulations § 20.2042-1(c)(6), 21 Fed. Reg. 7850, 7886 (1956). (Emphasis added.)

58. See pp. 197-99 *supra*.

The crude result of these rules is that unless both the stock held by the executor and the stock held by each beneficiary is redeemed, the payment by the corporation to the executor of the purchase price, whether or not pursuant to a buy-sell agreement, may produce a taxable dividend to the extent of the accumulated earnings and profits of the corporation. Revenue Ruling 56-103<sup>59</sup> suggests the very serious problems these sections create. In the situation presented in the ruling the corporation had one hundred shares issued and outstanding. Forty-eight shares were owned by the son, twenty-seven shares by the father (an aggregate of seventy-five, or seventy-five per cent owned by both); the remaining twenty-five (twenty-five per cent) were held by employees of the corporation. The sole beneficiary of the father's estate was the son. On the father's death, pursuant to the buy-sell agreement, a number of the father's shares were purchased by the corporation at the price fixed in the agreement (book value as of the date of death) and the remaining shares, which had been held by the father, were purchased at the same price with the approval of the minority shareholders. After the redemption, the father's interest had disappeared; the employees held twenty-five shares, while the son continued to hold his forty-eight shares, which constituted  $\frac{48}{73}$  or sixty-six per cent of the outstanding stock of the corporation. A ruling was requested as to the tax consequences of this redemption of the father's shares: was it a sale taxable as a capital gain, or a dividend, taxable as ordinary income? The Treasury held that the redemption was taxable as a dividend. Its reasoning, which seems to be inexorably, if intricately required by the combination of section 302 and section 318 of the Code, was as follows: section 302, which governs distributions and redemptions of stock, provides that<sup>60</sup> the provisions of section 318, which attribute ownership of stock by one person to that of another, would apply. Included in section 318 is section 318(a)(2),

59. Rev. Rul. 56-103, 1956-1 Cum. Bull. 159.

60. Except under certain conditions with respect to the family attribution rules in Int. Rev. Code of 1954, § 318(a)(1). For example, if Silas sold out to Thomas during his life by causing the corporation to redeem his shares, the transaction would not effect a taxable dividend merely by attribution of Silas' stock to Thomas under § 318, since § 302(c)(2) provides that the family attribution rules contained in § 318(a)(1) shall not apply on a complete termination of interest. The difficulty is that on Silas' death his estate owns the stock and the estate attribution rules in § 318(a)(2) are applicable. T.D. 6152, §§ 1.302-4, 1.318-3(a), Example (1), 1955-2 Cum. Bull. 61, 76, 126-27. Even a redemption during Silas' life may be subject to a dividend danger, however, on the theory that the redemption is in fact a satisfaction of the individual obligation of the remaining shareholder, Thomas. Compare *Louis H. Zipp*, 28 T.C. No. 32 (April 30, 1957), with *Zenzy v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954); *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947), limited acquiescence in Rev. Rul. 54-458, 1954-2 Cum. Bull. 167 (1939 Code), and Rev. Rul. 55-745, 1955-2 Cum. Bull. 223 (1954 Code), indicating there is no dividend tax to the selling stockholder.



which states that "stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as being owned by the partnership or estate." The ruling therefore starts from the premise that, under section 318(a)(2), the estate is treated as not only owning the twenty-seven shares held by the father, but also the forty-eight shares held by the son, who was the beneficiary of his estate. We therefore start computation and analysis with the assumption that the estate is deemed to have owned seventy-five out of one hundred shares, or seventy-five per cent.

We next go back to section 302 to see if this redemption qualifies for one of the types which is to be treated as a sale or exchange. Since there is little basis upon which to predict with any certainty whether a particular transaction will fall within or without the general clause referring to a redemption "not essentially equivalent to a dividend" contained in section 302(b)(1), we move to the mathematical criteria contained in two subdivisions of section 302(b): subdivision (2), a substantially disproportionate redemption of stock, and subdivision (3), a termination of shareholder's interest. To qualify under subsection (2), as a substantially disproportionate redemption, a shareholder's interest must be reduced to less than eighty per cent of the percentage of ownership (not the number of shares) he held prior to the redemption. Eighty per cent of seventy-five per cent is sixty per cent, the point below which the aggregate holdings of the father and son must be reduced to qualify the redemption as disproportionate. Since the son would continue to own  $4\frac{8}{13}$ , or sixty-six per cent, the transaction fails to qualify under section 302(b)(2). Moreover, since the estate is treated as continuing to own constructively after the redemption the stock held by the son, there is no termination of the estate's interest and section 302(b)(3) is not available. The ruling goes on to hold, gratuitously, that:

"... as the relative stock interest of the principal shareholder was not materially changed by the redemption, the distribution to him is equivalent to a dividend . . . . The fact that the redemption is pursuant to a contract between the corporation and the decedent does not appear to be significant for this purpose."<sup>61</sup>

How large an interest in the father's estate will be necessary to bring about this calamity? It will be recalled that Silas left Thomas the family photographic album. The statute does not, in requiring attribution from the *beneficiary* to the *estate*, distinguish between the types of interest in an estate or the value of such interest, and does not define the term "beneficiary."<sup>62</sup> The House bill originally did not require attribution

61. Rev. Rul. 56-103, 1956-1 Cum. Bull. 159, at 160.

62. Consider Int. Rev. Code of 1954, § 318(a)(2)(B), and the regulations thereunder, T.D. 6152, § 1.318-2, 1955-2 Cum. Bull. 61, 124-25, distinguishing between vested and contingent interests and considering the actuarial value of the interests in the trusts. See

to a trust unless the beneficiary had an interest of at least fifty per cent of the value of the corpus or of the income.<sup>63</sup> Since the phrases "proportionately" employed in the first sentence of section 318(a)(2)(A) and "actuarial interest" employed in the subdivision dealing with trusts<sup>64</sup> do not appear in the sentence requiring attribution from a beneficiary of an estate to the estate, it must be assumed that the attribution will be required regardless of the nature or value of the bequest. The Regulations so indicate, in stating that "the term 'beneficiary' includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution."<sup>65</sup> Theoretically, therefore, Thomas' right to receive the family album alone would require the addition of the stock held by him to the stock held by his father in determining the taxability as a dividend of any redemption of stock pursuant to the buy-sell agreement. Under New York law, for example, even specifically bequeathed property is "subject to administration by the executor"<sup>66</sup> for payment of debts, although a marshalling of assets is required, so that payment will be made first from the residue, in the absence of contrary directions in the will.<sup>67</sup> We may hope that the Internal Revenue Service will adopt the practical rule that where the residue is clearly adequate for the payment of debts a legatee of specifically bequeathed property is not a "beneficiary" of the estate for purposes of section 318.<sup>68</sup> The Treasury has been kind enough to include some helpful language in other definitions:

"§ 1.318-3. ESTATES, TRUSTS, AND OPTIONS.—(a) For the purpose of applying section 318(a) relating to estates, property of a decedent shall be considered as owned by his estate if such property is subject to administration by the executor or administrator for the purpose of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death. The term 'beneficiary' includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution. A person shall no longer be considered a beneficiary of an estate when all the property to which he is entitled has been received by him; when he no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property or to seek payment

also the reverse attribution, i.e., from the estate to the beneficiary, where Thomas is deemed to own only his proportionate share.

63. Mertens, *Federal Income Taxation*, Code Commentary, § 318(a)(2)(A):2 (1955).

64. Int. Rev. Code of 1954, § 318(a)(2)(B).

65. T.D. 6152, § 1.318-3, 1955-2 Cum. Bull. 61, 126-27.

66. Id., 1955-2 Cum. Bull. at 126.

67. N.Y. Surr. Ct. Act. § 214.

68. Cf. T.D. 6152, § 1.318-3(a), Example (2), 1955-2 Cum. Bull. 61, 127, which treats the recipient of a remainder following a legal life estate as not a beneficiary because he has "... no direct present interest ... in the income produced by such property."

from him by contribution or otherwise to satisfy claims against the estate or expenses of administration. When, pursuant to the preceding sentence, a person ceases to be a beneficiary, stock owned by him shall not thereafter be considered owned by the estate, and stock owned by the estate shall not thereafter be considered owned by him."<sup>69</sup>

The suggestion has been made that, to avoid the effect of section 302 and section 318, the redemption should be delayed until distribution of the property to the beneficiary has taken place. But under the provisions of the foregoing regulation, this might produce very real, practical problems. Frequently the cash to be derived from the sale of the stock will be the principal source of not only expenses of administration and taxes (which can under some circumstances be taken out free of dividend tax under section 303),<sup>70</sup> but the principal source of distribution and establishment of the legacies and other bequests provided in the will. Until the executor is paid for the shares, he holds stock in the corporation and must, in the pursuance of his duty, exercise control and supervision of the decedent's interest. Accordingly, a principal purpose of the buy-sell agreement will be defeated if redemption is withheld until there is "... a remote possibility that it will be necessary for the estate to seek the return of property or to seek payment from him by contribution or otherwise to satisfy claims against the estate or expenses of administration."<sup>71</sup> If, as often happens, as a result of carefully laid plans of estate planners, the next beneficiary of the estate is a trust in which the son is beneficiary, the same problem may be presented in more complex form.<sup>72</sup>

One may doubt whether the regulation will continue in its present form when the Commissioner considers the application of the "step transaction" rule to it. Suppose a payment of a bequest to the beneficiary (enabled by a loan to the executor, for example) is followed immediately by a redemption of shares. The Commissioner may well decide to tie the two transactions together, and apply the attribution rules nevertheless. Perhaps the solution suggested facetiously earlier in this article is not facetious after all: if a taxable dividend is a danger, wills and ancillary instruments should be so drawn as to preclude the promisee under a buy-sell agreement from being treated as a "beneficiary" of the estate. Such devices as inter vivos trusts, inter vivos gifts, etc., will have to be used with greater frequency.<sup>73</sup>

---

69. *Id.*, 1955-2 Cum. Bull. at 126.

70. Generally, where the value of all stock in the corporation held by the decedent and includable in the gross estate has a value of at least 35% of the gross estate or 50% of the taxable net estate.

71. T.D. 6152, § 1.318-3(a), 1955-2 Cum. Bull. 61, 126.

72. Int. Rev. Code of 1954, § 318(a)(2)(B).

73. See Winton & Hoffman, *supra* note 19, at 368-71. An interesting possibility is a

## THE CROSS-PURCHASE ARRANGEMENT

Now the question may fairly be asked: why not entitle this article "Decline and Fall, or the Perils of the *Stock Redemption* Agreement"? A short answer would be that in the area to which this article has been addressed, namely closely-held corporations where the purchaser has no independent estate, the stock redemption agreement, which makes available the funds and assets of the corporation, will frequently be the only practicable arrangement. But while the dividend danger involved in the payment of the premiums and the distribution of the proceeds at death is peculiar to the redemption agreement, other serious problems such as the indefinite valuation criteria, the refusal of the Service to recognize the validity of an agreement that does not contain restrictions applicable during life, and the appellate division's interpretation of section 124 of the Decedent Estate Law, are equally applicable to the cross-purchase arrangement. Some future article will have to discuss whether there is life in the cross-purchase method in spite of these upheavals.

## THERAPY

The draftsman is not, of course, powerless to meet the threats and complexities produced by these recent developments in the law. By taking appropriate precautions we may ameliorate or reduce, if not eliminate, the risks presented. For example, to avoid the effect of the *Prunier* case, we could provide that only part of the proceeds would be used for the acquisition of the stock of the decedent; give neither the survivor nor the decedent stockholder any rights in the policies whatsoever. We can resort to section 303 as a means of assuring the estate the cash required to pay estate taxes, funeral and administration expenses. To avoid dividend danger in the consequences of section 318, we could eliminate Tom as a beneficiary of his father's estate, or at least pay him off early in the course of administration before the redemption is effected. By an appropriate tax clause in Silas' will we may assure Tom that any additional tax resulting from a disregard by the Internal Revenue Service of the contract price in valuing the stock will be charged to the residuary estate and not to him (although many skilled draftsmen would blanch at a tax clause so broad or so suggestive as to include a "purchaser," despite the *Galewitz* decision). And with good fortune on our side, we may come out all right. Yet these may be patch-work remedies. All are aware of the importance of form in achieving, or failing to achieve, tax objec-

---

kind of intellectual "renvoi" which would result if the Commissioner, despite his regulation, were to repay the compliment to tax law by citing the *Galewitz* case and N.Y. Deced. Est. Law § 124 as proof that the income beneficiary or trustee of an inter vivos trust was a "beneficiary" to whom the estate attribution rules should apply.

tives. But care must be taken that formal changes to meet the carnivorous nature of the "revenooer" do not intrude too much upon the other responsibilities as draftsmen and counsel.<sup>74</sup> I wonder if this is not the time to go back to the fundamental purpose of these arrangements? If the tax consequences of the buy-sell agreement cannot be predicted—and there is certainly uncertainty if the purchaser is a member of the decedent's family—perhaps resort to other tax and estate planning procedures should be taken. The decision as to whether the shares should be sold and the funds of the corporation used for that purpose is essentially a decision which everyone would prefer to make at the time when the facts are known, namely at the decedent's death. There is great merit to limiting the arrangement, for example, to an option in the corporation or in the decedent's executor to assure the decedent or the corporation, as the case may be, of the funds or the control required. By such procedures as the creation and gift of non-voting preferred or common stock, we may preserve the father's control during his lifetime, and at the same time reduce the estate tax impact at his death. By shifting the emphasis from the estate tax valuation back to the substantive family settlement, where it belongs, perhaps not only the volume of tax litigation, but the volume of tax literature as well, will be reduced!

---

74. See, e.g., Winton & Hoffman, *supra* note 19, where the authors consider, in an apparently serious vein, the following steps to avoid the dividend danger created by Int. Rev. Code of 1954, §§ 302, 318: leaving the daughter, her children and her husband out of the father's will; having the daughter make a gift of her own stock to her infant children; creation of a legal life estate in the corporate shares.